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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 132

MARGARET L. HOLT and KATHLEEN L. McMAHON, individually and on behalf of all other shareholders of Alleghany Corporation similarly situated,

Petitioners,

—against—

ALLAN P. KIRBY, CHARLES T. IRELAND, JR., FRED M. KIRBY and ALLEGHANY CORPORATION,

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONERS

This is an action to set aside a fraudulent settlement of prior stockholder derivative actions charging a violation of § 14(a) of the Securities Exchange Act of 1934. The ultimate relief sought is return to Alleghany Corporation ("Alleghany") of stock unlawfully taken from its portfolio, or recovery of damages measured by the value of that stock, now over $62,000,000. Such relief was demanded in the settled actions. Those actions alleged Allan P. Kirby ("Kirby"), President of Alleghany, and three co-directors, took 48,225 Class A shares of Investors Diversified Services, Inc. ("IDS") from Alleghany's investment portfolio by means of false and misleading proxy material violating both the Securities Exchange Act of 1934 and the common law.

The central issue on this appeal is:

> Can corporate directors charged under the Securities Exchange Act of 1934 with unlawfully concealing inside information from shareholders to obtain proxies approving a self-dealing transaction retain the benefit of a judicially approved settlement of their liability where that settlement was procured by the directors' continued concealment of that inside information during the settlement hearings?

The court below, dividing 4 to 4 on rehearing, said yes: the directors' duty of disclosure runs only to the commencement of litigation. That ruling is in error. It makes the courts a weak link in the enforcement of the Securities Acts by rewarding continued concealment by insiders. That weakness is created by imposing on insiders lesser standards of disclosure in judicial settlement hearings than are required under the Exchange Act in the first instance.

OPINIONS BELOW

The opinion of the evenly-divided *en banc* Court of Appeals (R. 2375) is reported *sub nom. Alleghany Corp.* v. *Kirby*, at 340 F. 2d 311 (1965). The opinions of the original panel of the Court of Appeals (R. 2329 et seq.) and the District Court (R. 2287) are reported at 333 F. 2d 327 (1964) and 218 F. Supp. 164 (1963), respectively.

JURISDICTION

The judgment of the Court of Appeals on rehearing *en banc* was entered January 12, 1965 (R. 2377).

On April 13, 1965 Mr. Justice Harlan enlarged the time for filing a petition for a writ of certiorari pending the Second Circuit's determination of an appeal as to petitioners' right to intervene to present such petition (R. 2389). That appeal being decided adversely to petitioners by a divided panel of the Second Circuit, Mr. Justice Harlan on April 27, 1965 further extended the time to petition on the merits (No. 132) to May 12, 1965, provided that a petition as to the right of intervention (No. 131) also was filed by that date (R. 2390). Both petitions were filed May 12, 1965 and granted June 1, 1965. At that time the appeals were consolidated for argument (R. 2391-2).

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Where federal statutes (Section 14(a) of the Securities Exchange Act of 1934 and Rule X-14A-9) impose upon corporate directors standards of disclosure deemed necessary for the protection of the interests of shareholders, should a federal district court apply a comparable federal standard of disclosure in determining whether derivative actions alleging violation of those statutes have been fraudulently settled?

2. Should the rule of *Erie* v. *Tompkins*, the principles of *res judicata*, or considerations of comity foreclose a federal district court from setting aside the settlement of a § 14(a) claim under the correct federal standard because that settlement was approved by a state rather than federal judgment?

3. If so, would the proper application of state law in any event require nullification of the state court judgment?

4. Must a director-defendant who controls the corporation and who seeks court approval of a settlement of a derivative action against him reveal to the court that the attorney who was appearing in the proceedings as the representative of the corporation had in fact been the director's personal representative in the settlement negotiations and had been substituted as attorney for the corporation solely to facilitate the settlement hearings? Did the attorney have such a duty?

STATUTE AND RULE INVOLVED

The relevant provisions of the Securities Exchange Act of 1934, 15 U. S. C. §§ 78b, 78n, 78aa and Rule 14A-9 are set forth in the Appendix, *infra* (pp. 1a-5a).

STATEMENT

In 1949, Alleghany, a publicly-owned and listed company, was controlled by Kirby, its President and largest single stockholder, and Robert R. Young ("Young"), its Board Chairman (R. 1012, 1032). Those two, together with Robert W. Purcell ("Purcell"), Vice Chairman of the Board, are the leading actors both in the events giving rise to the prior actions and the settlement attacked here.

A. *The Illegal Transaction Giving Rise to the Prior Derivative Actions.* In April, 1949, Alleghany, after an exhaustive investigation by Kirby, Young and Purcell, and at their urging, purchased a controlling block of 85,660 shares of IDS common stock at $18.50 a share (R. 1634, 416, 538-539, 582-588, 1155, 455-456, 1170-1172, 1870, 1157, 1167-1168, 1634-1635).[1] Alleghany concurrently purchased 48,225 shares of IDS Class A non-voting stock at $8.15 average per share as a "long-term investment". Except for being

[1]IDS was and is a Minneapolis based registered face amount certificate company and investment adviser to open-end investment companies or "mutual funds" (R. 1633-1634).

non-voting, the IDS Class A shares were identical with the common shares (R. 1634-1635, 1870-1871, 1633, 1018).

Upon acquiring control, in April, 1949, Young and Kirby placed Purcell and J. J. Anzalone ("Anzalone"), Alleghany's Secretary and a director, on the IDS Board for the express purpose of keeping Kirby and Young fully informed as to IDS' operations (R. 537, 1869). Key to their appraisals were projections or forecasts of IDS' income and expense, regularly prepared by IDS, by its subsidiaries, and by an independent actuarial firm. From these projections Kirby, Young, Purcell and Anzalone learned by August, 1949 that the per-share earnings of IDS, which had been $1.25 in 1948, were reliably forecast to be $4.59 in 1949, $5.67 in 1950, $7.80 in 1951, $10.41 in 1952 and $12.53 in 1953 (R. 632, 576, 578-579, 540-542, 585-589, 468, 611-613, 1175, 1147, 1176, 1148-1150, 616-618, 460, 1053, 1059, 1104-1118, 1119-1120, 2007). After receiving this inside information, Kirby, Young and Purcell decided to take the IDS Class A stock from the Alleghany portfolio for themselves.

On December 6, 1949 seven of Alleghany's ten directors met for a scheduled Board meeting (R. 1039). The meeting agenda did not mention any proposed action as to Alleghany's 48,225 IDS Class A shares (R. 566-567). Nevertheless, Young proposed to the meeting that this stock be made available solely to the officers of Alleghany in exchange for Alleghany preferred (R. 1039). The only persons qualified to take advantage of the offer were Kirby, Young, Purcell and Anzalone (R. 1031-1032, 1035-1038). These self-interested four not only were necessary for the meeting quorum but formed the majority of the seven directors present, all of whom voted in favor of Young's proposal (R. 1039-1041). The resolution permitted the four officers to tender Alleghany preferred stock at market in

exchange for Alleghany's entire portfolio of 48,225 IDS Class A shares at $8.15 per share (R. 1018, 1035-1038), the average price paid by Alleghany.

Following the December 6, 1949 meeting, a new set of projections was prepared by IDS (R. 1121-1135, 1136-1137, 1342-1343; see also 2353-2354). These forecast an enormous increase in the IDS per-share earnings over the five years 1950-1955. They forecast that the shares the insiders had offered themselves at $8.15 per share would earn over $24 per share in 1950 and that the earnings in each of the following four years would also greatly exceed the purchase price (R. 1121-1135). In the proxy material sent to the shareholders seeking their approval of the transaction, none of the inside information showing the spectacular rise in IDS earnings was revealed (R. 1029-1030, 1031-1038).[2]

B. ***The Prior Derivative Actions are Begun.*** Shortly after the exchange in May, 1950[3], the price of IDS stock began to climb. At one point the stock was worth $1,600 per share, giving the insiders a profit of two hundred times the purchase price on each share (R. 2360, n. 3).

In 1954, derivative actions were instituted on Alleghany's behalf to obtain, among other relief, return of the IDS stock wrongfully taken (R. 701-705, 943-959). The shareholders sought rescission on the ground that the proxy material soliciting approval of the exchange transaction was false and misleading under § 14(a) of the Securities Exchange Act of 1934 and Rule X-14 A-9 (R. 705,

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[2]All judges of the original panel of the Second Circuit agreed this proxy material was false and misleading (R. 2341, 2364-2366).

[3]Pursuant to the exchange offer, Kirby and Young each acquired 24,060 IDS Class A shares. Anzalone acquired 100 Class A shares (R. 1037). Purcell did not participate directly in the exchange but through a separate agreement he purchased 12,000 shares from Young and Kirby at $8.15 a share (R. 1029, 1205-1206).

958). Actions seeking this relief were brought in both the New York State Court and the District Court for the Southern District of New York.[4] Kirby was a named defendant in both actions, but was served only in the federal action (R. 2332, 2352).

C. *The Insiders' Concealments During Discovery and During Settlement Hearings.* Discovery proceedings were commenced in the federal action with the depositions of Young and David W. Wallace, successor to Anzalone as Alleghany's Secretary (R. 1621). Before the depositions were completed a settlement offer was made to plaintiffs' counsel, who accepted (R. 729-735, 1621-1622).[5] Although discovery took place in the federal court, the settlement was presented only to the state court for approval (R. 729). Kirby was a party to this settlement, which he asserts as a bar to this action (R. 736). The state court appointed a Referee to take evidence and report on the fairness and adequacy of the settlement offer (R. 741-743).

The pertinent issue before the state court Referee, as it was in the Federal discovery proceedings, was whether Kirby, Young, Purcell and Anzalone had inside information concerning the startling rise in IDS stock which was not disclosed to the Alleghany shareholders (R. 1598). From the start, plaintiffs' discovery had focused on this issue.

Prior to Young's deposition in the federal action, plaintiffs' counsel made a written demand for:

> "all forecasts or budgets concerning IDS and its subsidiaries, prepared by or for the use of Alleghany

[4]The actions in the state court were ultimately consolidated under the caption *Zenn et al.* v. *Anzalone et al.* A similar consolidation under the same caption took place in federal court (R. 701, 943). The same firm of attorneys, Messrs. Pomerantz, Levy & Haudek, were general counsel for plaintiffs in both courts.

[5]The defendants agreed to pay Alleghany $700,000 and to modify certain contracts they had with the company in exchange for dismissal of all the claims against them (R. 732-733), claims estimated to amount to $92,000,000 (R. 1500).

> or IDS and their officers and directors, during the year 1949, [and] the first six months of 1950 . . ." (R. 1339, 636-638).

Although many documents were produced, the projections concealed from the shareholders when the proxy material was furnished in 1950 were concealed again.[6]

At Young's deposition, the request for projections prepared in 1949 and 1950 was renewed and he was specifically asked to produce IDS reports (R. 1417). Again, the forecasts and projections were not produced.

At the hearings before the Referee—which occupied 35 hearing days over a five-month period—counsel for the objecting shareholders again explicitly demanded any documents which might reveal the insiders' information. The request included forecasts, projections and monthly reports. Witnesses, including Young and Purcell, were also pressed for the same information (R. 395-397, 1369-1371, 1408-1410, 1412-1416, 1474, 1476, 1460-1462, 2069-2074, 2357-2358). Counsel repeated verbatim the specific requests that had been made at Young's deposition eight months earlier (R. 1417):

> "I would ask you to have a check made for the existence of any such budgets or forecasts or projections of earnings in any form whatever, in the form of a memorandum or in the form of a financial statement, or a report, . . ."
>
> "I am referring most particularly to those covering the years 1949, 1950, 1953, 1954."

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[6]Compare list of documents produced in the prior actions (R. 1220 et seq.) with the forecasts and projections discovered in this action (see pages 11-14 *infra*).

D. *The Evasions and Deceits.*

These requests were met with evasions and in some instances outright deceit.

(1) THE WAAG CORRESPONDENCE. Judge Friendly, in his dissent (R. 2350, 2352-2357), focused on one glaring example of deceit by Young and Purcell: the Waag-Purcell-Young correspondence of July, 1954.

That correspondence was part of Young's preparation for discussions with Pomerantz, stockholders' general counsel. It consisted of a letter dated July, 1954 from Waag, Vice President and Controller of IDS, to Purcell (R. 1342) enclosing three schedules (R. 1344-1358), and a handwritten note from Purcell to Young (R. 1359-1360) forwarding the Waag letter with its three enclosures.

Two of the enclosures were innocuous and eventually were produced at the hearings before the Referee. Neither of those contained or mentioned projected income.[7] The third, never produced, contained a comparison of 1950 income with a *projection* of income for 1950 (R. 1347-1358). This projection showed IDS had forecast its earnings at $20 per share at a time when the insiders were getting ready to acquire it for $8.15 per share. The covering Waag letter noted that the 1950 projection "was most likely completed in January of 1950 . . .", five months before Kirby and the others took the IDS Stock[8] (R. 1343).

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[7]One was a retrospective quarterly analysis of income for 1949-1950 (R. 1344-1345), the other was a list of larger items included in commissions and participation project fees for 1950 by quarters (R. 1346).

[8]Defendants argued below that Waag was mistaken in this date. Judge Friendly refuted this by pointing out: "Purcell's request to Crabb, President of IDS, on May 10, five days before the exchange took place, for additional copies of the IDS projections showed that at least by this date, copies were in his possession." (R. 2353-2354).

Purcell's note to Young (after referring to Young's prospective meeting with Pomerantz) drew attention to this schedule, suggesting that Young

> ". . . note, among other things, on page 2 of the income account attached to the 'Comments on Operations' for December, 1950, that Income from Operations, i.e., before taxes or capital transactions, had been projected at $5,992,168, but turned out to be $8,600,444. *This may not be too helpful* as Income from Operations in 1949 was only $1,515,401." (R. 1359-1360) (Emphasis supplied.)

Necessarily, Young recognized that the schedule revealing the existence of a projection of 1950 income would "not be too helpful". It directly contradicted the directors' defense that the self-dealers had no inside information enabling them to foresee the spectacular rise in IDS earnings. Neither that schedule nor the Waag letter, stating that the projection was prepared in January, 1950, was ever produced either at Young's deposition or during the hearings before the Referee despite the repeated demands for precisely such documents.

Remembering that the Waag enclosures were in Young's possession before he testified, his behavior when two of counsel's demands were addressed directly to him is revealing. After the first, Young's attorney interjected that "a search has been made for all such reports and there are none in Alleghany's files" (R. 1414).[9] Young sat mute throughout this interchange, failing to mention the existence of any projections, including the one he had received from Purcell. Again, on deposition, Young was asked to

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[9]Daly, the attorney for Young, Kirby and later Alleghany, had never searched Alleghany's files (R. 522), but relied on Alleghany's personnel to search its files (R. 1410).

have a check made of Alleghany's files for any projections or forecasts covering the years 1949-1950. Young answered, "Gladly", "Surely", "Naturally", he would *check for* such documents (R. 1417). But his "checking", produced neither the Waag enclosure nor any other projections nor did it produce testimony relating to those projections. As a result, plaintiffs and the Referee were misled into believing that no such projections were in Alleghany's files, and more important, that Young had never seen them prior to the self-dealing transaction.

Judge Friendly found the Waag-Purcell-Young correspondence alone sufficient to require Kirby to return the illegally acquired IDS shares (R. 2351). While we believe, as did Judge Friendly, that the Waag-Purcell-Young deception is sufficient to set aside Kirby's settlement, the record has further instances of deception requiring the same result.

(2) THE PROJECTIONS AND ACTUARIAL STUDIES. All of the forecasts and projections prepared by IDS and its subsidiaries in the regular course of their operations were furnished to Purcell in Cleveland (R. 540-542), to Anzolone and to Charles Shipman a securities analyst in the employ of Alleghany in New York (538-541, 613-615). Young and Kirby received or where informed of the content, of these reports (R. 611-612, 1172-1175, 541). Thus, documents never disclosed included the IDS projections for the year 1949 (R. 1119-1120), and for the five-year period 1949 through 1953 (R. 1104-1118); and the projections prepared by the independent actuarial firm of Joseph Froggatt & Co. ("Froggatt") for the same five-year period (R. 1053-1060). Both the Froggatt five-year projection—which had been received by the insiders (R. 1172, 1174-1175, 564-565) prior to the taking of the IDS stock—and the IDS internal projection revealed that IDS expected a

steady increase in earnings and that by 1953, earnings would be nearly ten times those for 1948[10] (R. 1060).

Also concealed were IDS' yearly projection for 1950 (R. 1136-1137) and its five-year projection for the years 1950 through 1954 (R. 1121-1135). These projections had forecast for the insiders an even more drastic increase in IDS per-share earnings, before taxes and capital transactions, as follows:

Year	Projected Earnings Per Share
1950	$24.56
1951	15.85
1952	13.28
1953	15.17
1954	18.11

(3) THE STIVER REPORTS. Still other relevant documents were withheld: among them, a favorable report as to IDS prospects by Saunders, Stiver & Co. ("Stiver"), investment bankers hired by Purcell to investigate IDS prior to Alleghany's acquisition (R. 1157-1169). Stiver produced two reports. A preliminary report in January was doubtful as to the merits of purchasing control of IDS and raised serious questions as to its prospects (R. 1905-1932). The second, in March, 1949, reflecting an exhaustive investigation of IDS, shows the earlier fears were unfounded (R. 1157-1168). It strongly recommended purchase of IDS as a long-term investment by Alleghany (R. 1167-1168). Although Kirby, Young and Purcell received both Stiver reports, *only the unfavorable first report was produced* (R. 438-439, 1157, 1905, 1870, 1873, 1220, 1278). The concealment of the second was deliberate.[11]

[10]IDS earned $1.25 per share in 1948 (R. 1743, 1745).

[11]Purcell in his testimony before the Referee stated that *one* report was prepared by Stiver. He testified (R. 2001):

"Q. Did you make what you then considered to be a thorough investigation of the I. D. S. holdings and business affairs?

A. As thorough as I could

[Fn. cont'd p. 13]

The Referee not only heavily weighed that first report by the investment banking firm but specifically relied upon it in upholding the insiders' defense that the prospects of IDS were indeed questionable when they took its stock from Alleghany (R. 1634).

(4) THE MONTHLY REPORTS. In like manner, the defendant-directors selected those of the IDS monthly reports they would produce and those they would withhold. IDS prepared two types of monthly reports; one was the IDS Comparative Balance Sheet (*e.g.*, R. 1834-1841), the other was the IDS Summary of Operations (*e.g.*, R. 1092-1103). These two reports, while quite similar, differed in one critical respect. Thus, both reports contained columns reporting income from operations for the month in question as well as for the year to date, and a parallel column gave the figures for the same month of the preceding year. The Summaries of Operations, however, unlike the Comparative Balance Sheets, contained a third parallel column which gave the figures that *had been projected* for the month and period in question (*e.g.*, R. 1094). These projection figures were drawn from the IDS yearly projection prepared in January of each year (R. 1343, 541-542). Hence, production of them would have given away the fact that such projections existed and were regularly prepared at IDS.

Kirby and Purcell had received these reports every month. Young had been given a sample of them (R. 1175, 1147, 1148-1150, 617-618). Specific demands for such

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"Q. What did that include? A. It included a review of such published information as I could obtain, such as annual reports of the standard statistical services. I found those to be rather meager, so Mr. Young and I decided that we should try to get some special reports prepared, and one was prepared by Mr. Stiver of Cleveland, and one was prepared by Mr. Shipman who, at that time, was my assistant; and they did a great deal of special review and study. * * *"

documents had been repeatedly made (*e.g.*, R. 1339, 395-397, 1369-1371, 1414-1417, 1460-1461). Nonetheless up to the very last day of Young's testimony before the Referee, defendants had avoided producing either type of monthly report. Finally, on that last day, the Comparative Balance Sheets were produced and it was represented that these were the monthly reports asked for (R. 1467-1469). The Summaries of Operations which contained projection figures plaintiffs' counsel *was* looking for, were never produced.

(5) YOUNG'S AND PURCELL'S TESTIMONY. Although Young had a number, and Purcell had all, of these projections, and although before their testimony Waag had reminded Young and Purcell that projections for 1950 had "probably been prepared in January", Young and Purcell testified before the Referee that at the time of the transaction, IDS prospects were gloomy. Young testified that this "dog" [IDS] was on the brink of financial disaster (R. 1638 referring to testimony at Pl. Ex. 4 id., pp. 2902-2903, 2308-2309):

> "[I]t was the kind of situation in which there could be a total loss * * *. Well, the situation in the company at that time was in a very shaky condition; it had $440,000,000 of maturities to meet within the next few years, and did not have enough resources to meet those maturities; and important figures in the S. E. C., thoroughly familiar with the company's financial conditions *had predicted that the company would be unable to meet those maturities and would be forced into bankruptcy.*" (Emphasis supplied.)

Purcell likewise testified to a long list of specific "problems" allegedly confronting IDS when the insiders decided to take the stock; stating in summary that during 1949 and 1950

"It was a struggle to keep the company alive"; that if the Minnesota Banking Commissioner had persisted in his views the "company would have been in serious default and open for a petition for receivership" (R. 2008-2009, 2012-2015, 2020-2022, 2026, 2031).

Throughout, their testimony persistently cried down the prospects of IDS at the time the stock was taken; with equal persistence, they concealed the projections which would have shown such testimony to be false and would have destroyed the self-dealing directors' defense.

E. *The Effect of the Concealments on the Referee.* In the absence of the five-year actuarial studies, the one and five-year official IDS projections and the other evidence which showed the existence of such projections (*e.g.*, the Summaries of Operations, the Young-Purcell-Waag correspondence), the plaintiff shareholders were forced to base their entire response to the insiders on one Purcell letter that had been found (R. 1509). That letter, dated February 11, 1950, informed Young and Kirby the IDS mortgage department had 1950 business on its books which would result in quadrupled 1950 income for that department (R. 1186-1190). The letter made no mention of operating income forecasts by any other IDS department or for IDS as a whole; a fact the insiders urged in their brief to the state court (R. 2360). As Judge Friendly observed, the insiders minimized Purcell's letters as merely reporting "favorable trends in certain aspects of IDS activity" and touching "only a few of the multitude of problems and activities of the company" (R. 2360). Since the insiders had successfully concealed not only the projections for IDS as a whole but the projections for the five years beyond 1950, their contentions appeared correct. The Referee obviously accepted it, for *his report did not mention the Purcell letter.*

Having convinced the Referee of the unimportance of the February letter, Kirby here takes the opposite argument. Contrary to his briefs to the Referee, he now urges that the Purcell letter of February 11, 1950 adequately disclosed to that court the extent of the insiders' foreknowledge of the upsurge in IDS earnings; that all of the projections revealed for the first time in this case were really just cumulative of that single paragraph concerning the mortgage department. Judge Friendly in his dissent disposed of this contention, pointing out the "enormous difference between a paragraph in a general letter, commenting on the prospects of one department of IDS . . . and proof that shortly before making the settlement, Young and Purcell had been reminded of the existence of an official company forecast in early 1950, covering all departments, which negated any fear that the anticipated quadrupling of income from mortgage operations would be cancelled out and showed instead that this would be enhanced by other divisions." (R. 2359-2360).[12]

Having successfully withheld the projections and the other damaging evidence, Kirby, Young and Purcell urged that they "had no inside information from which they could have foreseen [IDS'] subsequent spectacular rise in value"

[12]The inadequacy of the February 1950 letter as a substitute for the full projections has been implicitly recognized by defendants in their previous briefs. In those briefs they have not relied on the letter alone, but have used it, coupled with certain assumptions, in an attempt to show that counsel for the derivative plaintiffs could have "constructed" a projection of earnings similar to the projected figures shown on the IDS yearly projection for 1950. This "do-it-yourself projection kit" which will undoubtedly be submitted to this Court suffers many fatal defects which need not be detailed here. Suffice it to say that it was, of course, never before the Referee; it simply did not exist until defendants created it for this case. More important, the constructed projection at best reproduces only 1950 earnings. It does not even suggest the inside information that was contained in the full five-year projections. Nor do defendants suggest that there is any substitute in the record for those five-year projections, or any evidence from which the Referee could have concluded that the insiders had those projections before they took the IDS stock.

(R. 1637-1638). Denied this crucial evidence, the Referee agreed (R. 2359, and see 1646). He recommended that the state court approve the settlement (R. 1712).

F. *Consummation of the Settlement.* The state court confirmed the Referee's report (R. 1717-1720), but the federal court (Dimock, U. S. D. J.) on September 22, 1959 refused to vacate an order which stood as a bar to settlement (R. 870-874). Following Judge Dimock's decision, Ireland informed Kirby that he would be called as the first witness on the renewed hearings in federal court (R. 417, 345-346, 386, 427, 414-415). Ireland also reminded Kirby that Young had perjured himself in the state court settlement hearings and that this would undoubtedly be brought out on the hearings in federal court (R. 417). Kirby thereupon asked his attorneys—who also represented Alleghany—for their opinion as to his exposure if he did not settle (R. 998, 1361-1362). He was advised that his potential personal liability arising out of the IDS transaction was $62,000,000 (R. 978-979). Spurred by counsel's advice as to liability, Kirby authorized new settlement negotiations through defendant Ireland (who became in November, 1959 an officer of Alleghany) (R. 998, 1361-1362) with Phillips acting for plaintiffs (R. 428, 481-482, 349, 370-371). Under Kirby's authorization, Ireland, in an attempt to buy off the claim against Kirby at the cheapest price, joined with the settlement offer a private deal for Phillips whereby Phillips would receive a position paying $45,000 a year for ten years (R. 2286; 486-487). Phillips rejected the bribe offer (R. 2287, 487). Eventually Ireland succeeded in negotiating a settlement of Kirby's liability for approximately $1,250,000 (R. 878, 883).

Since Alleghany had been without independent counsel throughout the negotiation of the settlement agreement (R. 500), it was suggested that Ireland, who had negotiated the settlement on Kirby's behalf, appear as Alleghany's counsel. The suggestion was acceptable to Kirby (R. 500).

The federal district court, like the plaintiffs, was still unaware of the inside information which Kirby, Young and Purcell had possessed, nor was it told of Young's perjury or that Ireland, who was now representing Alleghany, had negotiated Kirby's settlement. It approved the settlement and lifted the injunction (R. 1363-1364, 933-934, 938-940).

Defendants then went to the state court and obtained the judgment under attack here (R. 747-774).[13] The federal court action is still on the calendar [*Zenn* v. *Anzalone* (S.D.N.Y. Civ. No. 92-205)].[14]

G. *Commencement of This Action.* On September 8, 1960 John D. Murchison, his brother, Clint W. Murchison, Jr., and an unrelated Alleghany shareholder, Fossland, instituted this action to set aside or nullify Kirby's settlement (R. 1, 166-189). It claimed Kirby and Ireland had entered into a corrupt bargain with Phillips in order to achieve the grossly inadequate settlement which led to the state court judgment. Alleghany, still under Kirby's control, elected to actively defend the action (R. 88-89).

While the suit to set aside Kirby's settlement was pending, an insurgent slate led by the Murchisons was successful in a proxy contest to oust Kirby from control of Alleghany's management (R. 89). For the first time in 23 years, Alleghany was free of the control of Kirby and Young, and outsiders had access to its files (R. 90-91, 48). An examination of those files, as well as those of IDS, revealed the evidence so long concealed (R. 2352, 2334-2336). Alleghany thereupon sought the advice of independ-

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[13]No notice to stockholders was given at that time. Notice of the earlier settlement had been given but that settlement had been abandoned by all parties and rejected by the federal court.

[14]Defendants have not tried to dismiss that case, perhaps because notice to stockholders and federal court inquiry under Rule 23(c) would be required.

ent counsel, unassociated with this or the prior actions (R. 89-90). Such counsel embarked upon an investigation of Alleghany's files and an evaluation of the claims in this action. It recommended that Alleghany assume the prosecution of the action and amend the complaint to plead specifically the non-disclosure of inside information (R. 87-95). Alleghany's Board followed this advice and the corporation became the plaintiff (R. 101-102).

An amended complaint was tried before a judge without a jury, in early 1963, and was dismissed (R. 2328), the District Court concluding first that Alleghany had failed to prove a "corrupt bargain" between Kirby and Phillips and second that Kirby had no duty of disclosure in the prior litigation, that the non-disclosed documents were not material, and that even if a fraud had been perpetrated on the Referee and the courts, it was "intrinsic" fraud insufficient under state law to set aside Kirby's settlement (R. 2288-2328).

No appeal was taken as to the "corrupt bargain", but the corporation appealed as to the non-disclosure of inside information. The day before the appeal was heard, Kirby purchased sufficient Alleghany stock to give him direct control of the Corporation (R.13).

H. ***The Opinions of the Court of Appeals.*** The original panel which heard this case consisted of Judges Moore, Friendly and Kaufman. That panel split 2-1 in favor of affirmance (333 F. 2d 327 (1964)). Judge Moore wrote the majority opinion (R. 2329), Judge Kaufman a concurring opinion (R. 2347) and Judge Friendly wrote a dissent (R. 2350).

The entire panel agreed on three critical propositions:

1. That the 1950 transaction by which Kirby, Young and Purcell acquired the IDS shares was illegal and a classic example of fiduciary self-dealing (R. 2341, 2361-2366).

2. That the proxy material used by Kirby, Young and Purcell to obtain approval of that transaction was false and misleading (R. 2341, 2364-2366).

3. That facts and relevant documents were not disclosed during the course of the settlement negotiations and hearings regarding claims based upon that transaction (R. 2334-2366, 2348-2349, 2352-2359).

Nor did any member of the panel deny that the settlement ultimately approved by the courts was grossly inadequate (R. 2343, 2358, 2359, n. 3).[15]

Despite these substantial areas of agreement on the facts, Judges Moore and Kaufman split with Judge Friendly on the applicable principles of law and denied Alleghany the right to set aside the settlement of the underlying claim. Judge Moore, in writing the affirmance for the original panel,

(a) held that as soon as a self-dealing director is sued by shareholders for a § 14(a) violation, his duty of disclosure ceases; the director becomes an ordinary adversary with no greater obligation of disclosure than that required by court process (R. 2339, 2343-2344);

(b) held that although relevant documents were not disclosed, their non-disclosure was insufficient to upset a state court judgment (R. 2342-2343).

On the other hand, Judge Friendly in dissenting stated that he could "perceive no principle that would eliminate or even lessen the fiduciary obligations of directors who wish

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[15]Judge Moore calculated that "Kirby alone had profited at the expense of Alleghany in an amount in excess of $4,500,000" (R. 2330). Judge Moore's arithmetic ignored a 5-1 split in IDS stock as well as substantial stock dividends. An accurate account of Kirby's liability is found in Judge Friendly's opinion (R. 2359, n 3) which shows Kirby's personal liability to be $22,800,000 and his joint liability over $60,000,000. Kirby settled for $1,250,000 (R. 878-884), which in his tax bracket cost him only $99,000 (R. 2360, n. 3).

to settle a derivative action wherein they are charged with self-dealing" (R. 2350). He held that Kirby was liable for the concealments of his co-fiduciaries Young and Purcell (R. 2351-2352) (an aspect of the case ignored by Judge Moore) and that those concealments were material and hence sufficient to support the setting aside of Kirby's settlement (R. 2360-2361).

Judge Kaufman, in his concurring opinion, did not explicitly agree with Judge Moore as to his view of the absence of fiduciary duty in adversary litigation (R. 2347), nor did he explicitly reject Judge Friendly's finding that Kirby was liable for the concealments of his co-fiduciaries (R. 2347-2348). He did, however, find the concealments insufficient to upset the state court judgment (R. 2349-2350).

Alleghany's petition for rehearing *en banc* was granted by a vote of 4-3 (R. 2372-2373): Judges Waterman, Friendly, Smith and Hayes voting for rehearing; Judges Moore, Kaufman, and Marshall voting against. (Judge Lumbard abstained and one place on the bench was at the time vacant. After the filing of the principal briefs on rehearing, Judge Anderson was appointed to fill the vacancy.)

On January 12, 1965, the Second Circuit split 4-4 as to the proper disposition of the case; Judges Moore, Kaufman, Marshall and Anderson voting to affirm, and the four judges who had favored rehearing, voting to reverse (R. 2375-2376). As a result of that split, the District Court's judgment was affirmed.

SUMMARY OF ARGUMENT

The key issues presented here are: (1) Should directors settling a derivative claim against them based upon violations of § 14(a) of the Securities Exchange Act of 1934 be held to a duty of disclosure consistent with the policy

of that statute? (2) If so, does violation of that duty of disclosure vitiate the settlement? We believe both questions should be answered yes.

I.

Stated simply, the argument in Point I is: § 14(a) of the Securities Exchange Act of 1934 imposes a duty of full disclosure. To effectuate the purposes of the Act, and in particular the purpose of § 14(a), a like duty must exist when suit is brought for its violation. Failure to discharge that duty constitutes fraud sufficient to set aside the settlement challenged here.

Shareholder protection through disclosure is at the heart of § 14(a) and the entire Securities Exchange Act. The language of the Act, its legislative history, the courts, and the commentators leave no doubt on that point.[16]

Unless stringent standards of disclosure are imposed upon corporate directors when a § 14(a) action is being adjudicated or settled, a true evaluation of the claim by the shareholders affected and by the court is impossible. A rule allowing challenged directors, who control the corporate files, to select the evidence they will reveal and to conceal the rest gives those directors the vicious power to prevent appraisal of the claim against them. If a judicial settlement obtained by concealing is deemed valid, both the effectiveness of the statute and the efforts to enforce it are impaired. If the court's settlement procedures are thus utilized, they become a loophole in the investor protection intended by Congress.

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[16]E.g., H. R. Rep. No. 1383, 73d Cong. 2d Sess. 11 (1934); S. Rep. No. 792, 73d Cong. 2d Sess. 12 (1934); Hearings on H. R. 7852 and H. R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 138, 140, 144 (1934); J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Fleischer, *Federal Corporation Law: An Assessment*, 78 Harv. L. Rev. 1146 (1965).

Measured by the necessary federal standards, the settlement here attacked was obtained by a fraud on the federal and state courts as well as upon Alleghany's shareholders. The insiders' failure to disclose the IDS earnings forecasts, or the information therein, prevented a fair appraisal of the settlement just as the absence of the same inside information from the proxy statements made that proxy material false and misleading.[17] A different rule would allow violators to obtain immunity by persisting in their concealments.

In principle, the rule of full disclosure should apply to the settlement of every claim asserted under § 14(a). While there appears no need to limit the rule, two special circumstances of this case allow the framing of a rule no broader than one requiring a federal court to refuse to be bound by a settlement of a § 14(a) claim where self-dealing director-defendants have failed to disclose fully in the face of a specific demand for the concealed evidence. Those circumstances are:

1. The false and misleading proxy material which gave rise to the § 14(a) claim which was settled here related to a self-dealing transaction. Directors are, of course, fiduciaries and the common law has imposed upon self-dealing directors the same fiduciary duties imposed upon trustees.[18] Trustees have repeatedly been held to be under a duty of full disclosure when challenged in litigation.[19] Hence, the federal rule

[17]Moreover, in the final hearings before the federal and state courts, Kirby and Ireland were under a duty to tell the courts that Alleghany did not have independent counsel (See pp. 39-40, *infra*). Failure to do so aggravated the fraud.

[18]E.g., Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946); Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163 (1901). See Upson v. Otis, 155 F.2d 606, 611 (2d Cir. 1946).

[19]E.g., Ferguson v. Wachs, 96 F.2d 910 (7th Cir. 1938). Erbe v. Lincoln Rochester Trust Co., 3 N.Y.2d 321, 144 N.E.2d 78 (1957), subsequent complaint upheld, 13 A.D.2d 211, 214 N.Y.S.2d 849 (4th Dep't. 1961, appeal dismissed 11 N.Y.2d 754, 181 N.E.2d 629 (1962).

of full disclosure called for here is supported both by the policy of the Act and by directly relevant common law principles.[20]

2. The documents not disclosed here had been specifically demanded by the plaintiff shareholders during federal discovery and the state settlement proceedings. Failure by a fiduciary to respond honestly to demands in litigation has uniformly been deemed sufficient to invalidate a judgment,[21] i.e., it is treated as an exception to the intrinsic fraud rule. Thus, the duty to disclose argued for here finds additional support in the common law obligation of fiduciaries to make an honest disclosure when challenged in litigation.[22]

The validity of the rule is not diminished because it requires disclosure after litigation begins. Here, as in other areas of the law, policy considerations dictate that reliance cannot be placed entirely on discovery procedures, or even on the adversary nature of litigation, to achieve a just result.[23] This is especially so in instances where, as here, discovery demands were consciously frustrated and a true adversary proceeding was prevented.

Nor does full disclosure deprive defendant-directors of their right to defend themselves. Of course, defendant-directors, in actions brought under § 14(a) have a right to defend themselves, but not on a set of facts which they have selected or on a record which they have tailored to their defense.

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[20]Because of the common law principles stated, we believe the same have been reached under the proper application of state law.

[21]Fiske v. Buder, 125 F.2d 841, 848 (8th Cir. 1942); Hewitt v. Hewitt, 17 F.2d 716, 717 (9th Cir. 1927).

[22]In addition, the presence of this circumstance removes from this case the more difficult question of what the duty would be where the relevance of the non-disclosed information had not been sharply emphasized by a precise demand.

[23]See the trustee cases cited above, page 23, n. 19.

The contention that full disclosure would necessarily preclude a defense is based not on the generality of cases, but on the facts of this case alone. The record here may well support the conclusion that after full disclosure, Kirby, Young and Purcell would, indeed, have been without a defense. But many challenged directors who have dealt for themselves with corporation property, i.e., those who have dealt honestly, will be able to reveal all and still successfully defend themselves.

II.

Neither *Erie* v. *Tompkins,* nor the existence of a state court judgment approving the settlement prevents application of federal law.

Erie plainly has no relevance here. Where a federal claim has been settled, either in a federal or a state court, the validity of the settlement is controlled by federal law.[24]

Nor does the existence of a state court judgment bring into play considerations of res judicata and comity which would prevent the application of the correct federal rule.

Res judicata cannot apply because the issues in this case have never been tried. The question in the prior action was whether proxy material issued by insiders was false and misleading; the question here is whether those insiders procured their settlement by fraud. Likewise, no consideration of comity requires that a federal court abandon federal standards of investor protection simply because a state court was fraudulently induced to approve a settlement of the federal claim. This is especially true where, as here, the fraud was worked in parallel actions in both the federal and state courts.

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[24]Dice v. Akron, C. & Y. R.R., 342 U.S. 359, 361-2 (1952); Garrett v. Moore-McCormack Co., 317 U.S. 239, 245-6 (1942).

Nor, in the face of the countervailing policy considerations present here, should the federal courts be foreclosed by any finality-of-litigation argument, no matter how salutary that principle may be in other, less sensitive situations.

ARGUMENT

I. THE FAILURE OF DIRECTORS TO DISCLOSE CRUCIAL INFORMATION WHEN SETTLING A CLAIM BASED UPON THEIR VIOLATION OF § 14(a) IS A FRAUD SUFFICIENT TO VITIATE SETTLEMENT WITH THEIR CORPORATION.

The basic issue in this case is focused by three facts, about which there was no dispute among the judges in the Court of Appeals:

(1) The self-dealing transaction was illegal (R. 2341, 2361-2366).

(2) The proxy material seeking approval of that transaction violated § 14(a) by reason of its misrepresentations and its failure to disclose, among other things, the inside knowledge as to the projected rise in future earnings in IDS (R. 2341, 2364-2366).

(3) The self-dealing directors, in settling the claim based upon the § 14(a) violation, failed to disclose to the courts information and documents relevant to that claim (R. 2334-2336, 2348-2349, 2352-2359).

Hence the question is posed: Does the non-disclosure, in light of the policy underlying § 14(a) and of the repeated demands for the concealed documents, constitute a sufficient basis under federal law for setting aside the settlement?

A. ***The Necessity of Full Disclosure When Insiders Are Challenged In the Courts.*** The basic policy of the Securities

Acts is stockholder protection through full disclosure.[25] § 14(a) and Rule 14a-9 were designed to effectuate that policy:

> "The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."[26]

This Court has recently held in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), that the policy of the Acts requires that shareholders have a private as well as a derivative right of action under § 14(a) if the statutory standard has been violated. In doing so, it stated (id. at 433):

> ". . . under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. As was said in *Sola Electric Co.* v. *Jefferson Electric Co.*, 317 U. S. 173, 176 (1942):
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> > 'When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted.' "

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[25]The legislative history of the Securities Acts makes clear the importance of disclosure, H. R. Rep. No. 1383, 73d Cong. 2d Sess. 11, 13, 14 (1934); S. Rep. No. 792, 73d Cong. 2d Sess. 12 (1934); Hearings on H. R. 7852 and H. R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 138, 140 (1934); see H. R. Rep. No. 1418, 88th Cong. 2d Sess. 4 (1964); S. Rep. No. 379, 88th Cong. 1st Sess. 6-9 (1963); as do the cases, SEC v. Capital Gains Bureau, 375 U.S. 180 (1963); and the commentators, Fleischer, *Federal Corporation Law: An Assessment*, 78 Harv. L. Rev. 1146 (1965); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361 (1965).

[26]J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964).

It holds that private enforcement of the proxy rules, while not specifically referred to in the statute, is a "necessary supplement to Commission action".

So, too, the duty of full disclosure prior to settlement of actions brought for violation of § 14(a) must persist as a necessary supplement to the statute and the Commission's efforts to enforce it. For the same reason, where a judicially approved settlement of a § 14(a) claim has been obtained without discharging that duty, the settlement cannot bar a further attempt to enforce the statute. While the duty to disclose in litigation and the consequences of non-discharge are not found in the words of § 14(a), they are found in the policy of the statute and are rooted in the necessity that the courts adopt rules which will further that policy. Hence, it can be said that the rule proposed here is implied in the statute.

But, it is, of course, not necessary to find the duty to disclose prior to settlement and the consequences for breach of that duty either explicitly set forth or implied in the statute. It is sufficient that the rule proposed here is necessary to give effect to the statute's purpose. See *Mercoid Corp.* v. *Mid-Continent Investment Co.*, 320 U.S. 661, 669-670 (1944), where it was urged that an antitrust defense was barred by res judicata because it might have been raised in an earlier action. This Court held that the doctrine of res judicata did not foreclose litigation of the defense in a second action, because to do so would be contrary to the policy underlying the antitrust laws:

> "And the determination of that policy is not 'at the mercy' of the parties nor dependent on the usual rules governing the settlement of private litigation". (Citation omitted.)

The statutory purpose, we believe, was at the base of Judge Friendly's dissent when he stated that the bringing

of a suit should not signal the lowering of the standards of disclosure. He wrote (R. 2350-2351):

> "I see no reason why [the directors'] obligation of fair dealing and full disclosure to a court passing on the settlement should be a whit less than their previous duty to disinterested co-directors and to stockholders."

Judge Moore disagreed. His view was that the directors here were under a duty prior to litigation but when litigation began the duty evaporated (R. 2340):

> "If the defendant-directors were fiduciaries, they certainly were not considered as such by the stockholder-plaintiffs. They were under attack and entitled to defend themselves by all legal means. . . ."[27]

Judge Moore's holding will mean that dishonest directors, running the corporation on the one hand, and dealing for themselves with the corporation on the other, will be encouraged to withhold inside information related to the property they are acquiring from the corporation. Under Judge Moore's rule, the less disclosed at any stage of the transaction and in subsequent litigation, the better the odds of getting away with a fraudulent deal. Once successful in maneuvering a settlement through a court, as here, the directors will be allowed, under the rule stated by Judge Moore, to keep the property illegally taken from the stockholders—the very persons Congress and the SEC are attempting to protect.

Judge Friendly's view, that it is "vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that

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[27]In his concurring opinion, Judge Kaufman did not expressly agree with Judge Moore on this point. He found it unnecessary to decide this issue (R. 2347).

a breach was not consequential to the most icy scrutiny", is consistent with the statutory purpose and the role of the federal courts in stockholder derivative litigation (R. 2368).[28] It is more likely to insure that repetitions of self-dealing of the kind involved here—which even Judge Moore found to be illegal—will not be repeated. It will also insure a just result in those instances when directors, as here, grossly abuse their trust.

The rule propounded by Judge Friendly, in effect, imposes the same standard of morality upon directors when *they come into court* seeking to settle a § 14(a) claim, as the statute imposes when the directors are dealing with their corporation's shareholders in the original transaction or in proxy statements. It may be argued that it is not this Court's role to enforce business morality. We disagree. In a society in which so much wealth and power rests in the hands of corporate directors, business morality is not only a legitimate, but a pressing concern for our courts as well as our legislature.[29]

B. The Application of the Correct Federal Standard in this Case. What does the requirement that there be "full disclosure" prior to settlement or adjudication of a § 14(a) claim mean generally, and what does it mean in the context of the present case?

Generally, the rule of full disclosure should apply to every settlement or adjudication of a § 14(a) claim, and it should require the setting aside of every unfair settlement where there has been a failure to disclose facts which the insider would have been required to disclose under § 14(a) at the time of the transaction. This case, however, does not

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[28]See Heddendorf v. Goldfine, 167 F. Supp. 915, 926 (D. Mass. 1958).

[29]Indeed, it is also the concern of the practicing attorney. See Cary, *The Case for Higher Corporate Standards,* Harv. Bus. Rev., Sept.-Oct. 1962, p. 53.

require the application of so broad a rule. Because of the presence of two circumstances, neither the formulation nor the application of the proper federal standard in this case involves a broad rule or a great departure from common law principles.

1. The false and misleading proxy material which gave rise to the § 14(a) claim related to a self-dealing transaction: The common law has approached the point of imposing upon self-dealing directors, who have been challanged in litigation, the very duty which we have urged is required by the proper federal rule.

Thus, in New York and Maryland (Alleghany's state of incorporation) self-dealing directors have been held to the same fiduciary duties as trustees.[30] Further, it has been held that trustees are under a duty to fully disclose when challenged in litigation, and that failure to discharge that duty is sufficient ground for setting aside a prior judgment.[31]

Hence, it should follow that self-dealing directors, like trustees, must fully disclose in litigation and their failure to do so should vitiate any judgment thus obtained.

A federal rule which would set aside a settlement of a § 14(a) claim against self-dealing directors who have not fully disclosed is, therefore, rooted not only in the policy underlying the Act, but in relevant common law principles.

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[30]Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946); Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., 16 Md. 456, 77 Am. Dec. 311 (1860); Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163 (1901); Sialkot Importing Corp. v. Berlin, 295 N.Y. 482, 68 N.E.2d 501 (1946); Wohl v. Miller, 5 A.D.2d 126, 167 N.Y.S.2d 233 (1st Dep't 1957); see Upson v. Otis, 155 F.2d 606 (2d Cir. 1946).

[31]Earll v. Picken, 113 F.2d 150 (D. C. Cir. 1940); Ferguson v. Wachs, 96 F.2d 910 (7th Cir. 1938); Erbe v. Lincoln Rochester Trust Co., 3 N.Y.2d 321, 144 N.E.2d 78 (1957), *subsequent complaint upheld,* 13 A.D.2d 211, 214 N.Y.S.2d 849 (4th Dep't 1961), appeal dismissed 11 N.Y.2d 754, 181 N.E.2d 620 (1962); Matter of Lautz's Estate, 128 Misc. 710, 220 N.Y. Supp. 782 (Surr. Ct. Erie Co. 1927); Matter of Colton, 173 Misc. 744, 18 N.Y.S.2d 766 (Surr. Ct. N.Y. Co. 1940); Matter of Schinasi, 3 N.Y.2d 22, 143 N.E.2d 390 (1957), reversing 2 A.D.2d 105, 153 N.Y.S.2d 503 (1st Dep't 1956), *which reversed* 208 Misc. 1056, 145 N.Y.S.2d 136 (Surr. Ct. N.Y. Co. 1955).

2. The concealed information was specifically demanded: In like manner, a holding that settlement of a § 14(a) claim should be set aside unless the defendant-directors had disclosed all information which had been specifically demanded in litigation finds support not only in the policy of the statute, but in common law principles as well.

In most jurisdictions, whether the failure to respond honestly to demands in litigation is a fraud sufficient to set aside a judgment depends, *in the ordinary case,* upon whether the fraud is deemed intrinsic or extrinsic; compare Federal Rule 60(b). Intrinsic fraud, which has been defined in New York as "no more than . . . perjury on the part of a successful party or his witness",[32] has been held insufficient to set aside a judgment. But fraud committed by a fiduciary has always been held to be an exception to the rule or has been deemed to be extrinsic, and hence, has always been held sufficient to set aside a judgment. *Fiske* v. *Buder,* 125 F.2d 841, 848 (8th Cir. 1942); *Ferguson* v. *Wachs,* 96 F.2d 910, 918 (7th Cir. 1938); *Hewitt* v. *Hewitt,* 17 F.2d 716, 717 (9th Cir. 1927); *Graver* v. *Faurot,* 76 Fed. 257, 261 (7th Cir.), certificate dismissed with opinion 162 U.S. 435 (1896); *Pickens* v. *Merriam,* 242 Fed. 363 (9th Cir. 1917). See *Griffith* v. *Bank of New York,* 147 F.2d 899 (2d Cir.), cert. den. 325 U. S. 874 (1945); 3 Freeman, *Judgments,* 2576 (5th Ed. 1925).[33]

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[32]Griffith v. Bank of New York, 147 F.2d 899, 903 (2d Cir.), cert. den. 325 U.S. 874 (1945) interpreting Crouse v. McVickar, 207 N.Y. 213, 100 N.E. 697 (1912).

[33]The law of New York is in accord: Erbe v. Lincoln Rochester Trust Co., 13 A.D.2d 211, 214 N.Y.S.2d 840 (4th Dep't 1961), *appeal dismissed* 11 N.Y.2d 754, 181 N.E.2d 629 (1962); Erbe v. Lincoln Rochester Trust Co, 3 N.Y.2d 321, 327, 144 N.E.2d 78 (1957), reversing 2 A.D.2d 242, 154 N.Y.S.2d 179 (4th Dep't 1956), which affirmed 1 Misc.2d 413, 145 N.Y.S.2d 788 (Sup. Ct. Monroe Co. 1955); Boston & Maine R. R. Co. v. Delaware & Hudson Co., 238 App. Div. 191, 195, 264 N.Y. Supp. 470 (3d Dep't 1933); Matter of Lautz's Estate, 128 Misc. 710, 220 N.Y. Supp. 782 (Surr. Ct. Erie Co. 1927); as is the law of other jurisdictions: In re Enger, 225 Minn. 299, 30 N.W.2d 694 (1948); Laun v. Kipp, 155 Wis. 347, 145 N.W. 183 (1914).

Neither the presence of self-dealing nor specific demands, however, should be necessary for reversal. There appears to be no reason why the federal rule requiring directors who wish to settle a § 14(a) claim to disclose all relevant information which they possess should be so limited. The presence of both of these circumstances here, however, permits reversal on a narrow ground, and the application of a rule which grows directly out of common law principles.[34]

Judge Moore rejected even this narrow rule. He conceded that self-dealing directors were under a duty to fully disclose prior to litigation, but held that once litigation begins that duty completely evaporates. He apparently accepted defendants' contention that a self-dealing director's obligations of disclosure in litigation are somehow inconsistent with the adversary system (R. 2339-2340).

The cases cited above (pp. 31-32) saw no such inconsistency. When a fiduciary is challenged, the courts have consistently refused to treat him like an ordinary litigant, who had been dealing with his adversary at arm's length, and have not relied on normal adversary devices to achieve a just result. They have imposed a duty of disclosure in litigation upon trustees, and have not hesitated to set aside judgments obtained by trustees where it has been shown that significant information has been withheld in a prior suit. The federal courts have had no more difficulty requiring disclosure by fiduciaries after litigation begins, than have the state courts. Particularly relevant here are cases

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[34]The third question presented by this brief asks if proper application of state law would require reversal. In order to answer that question we have included in our discussion of common law principles, cases from the two states whose law would be applicable, New York and Maryland. Upson v. Otis, 155 F. 2d. 606, 610 (2d Cir. 1946). Under the fiduciary principles discussed above, it appears that the same result should be reached under the common law as under the application of the federal rule.

where the courts have insisted that in derivative actions, the defendant directors must make full disclosure prior to court approval of a settlement. *Heddendorf* v. *Goldfine,* 167 F. Supp. 915 (D. Mass. 1956). Compare, *Masterson* v. *Pergament,* 203 F.2d 315 (6th Cir. 1953); see *Cohen* v. *Young,* 127 F. 2d 721 (6th Cir. 1942).

The issue is not whether a director can defend himself, but whether he should be allowed to keep the benefits of a settlement without disclosing the relevant information. Of course, a director has the right to defend, but only on a record which includes all relevant facts. If these facts do not easily lend themselves to a defense or, if as here, they allow virtually no defense at all, it is the self-dealing director, not the minority shareholders, who should bear the loss.

C. *The Concealments in the Hearing Before the Referee Require That the Settlement Be Set Aside.* The trial court and Judges Moore and Kaufman held that the settlement could be set aside only if the concealed documents were "at least . . . of the character required for a new trial"; i.e., that they "probably would have produced a different result" (R. 2342, 2349, 2325).

Defendants have urged that the trial court's test is the correct one, and that it was correct in concluding that the undisclosed documents would not have changed the result of the hearings before the Referee.[35] The latter contention boils down to an assertion that it was something other than the concealments which actually misled the Referee. In effect, defendants argue that the deliberate deceit fell short of its purpose. Defendants are too modest. The fraud was more successful than they are now willing

[35]Brief of Respondents Allan P. Kirby, et al., in Opposition to Petition for Certiorari (p. 14).

to acknowledge; the Referee found, as Kirby, Young and Purcell intended, that no undisclosed inside knowledge existed (R. 1637-1638, 1646, 1654).

The difficulty with defendants' contention that it was not the concealments which achieved this result is: there is nothing in the record, except the fraud, which can be credited with misleading the Referee. Neither the majority opinion nor the defendants have suggested what did mislead the Referee, if not the concealments. Nor have they supplied an answer to Judge Friendly's observation that if the proof which was in the record "had been supplemented by proof to the Referee that at the time of the exchange, Purcell and Young knew IDS was forecasting even higher earnings, could any rational mind have predicted that a court would decide for the defendants?"

Given the deliberate and successful nature of the concealments, defendants should not be heard to argue that the District Court was correct in its speculation that the concealed documents would not have changed the result. Once the complaining party shows that fraud was committed by an adversary in the prior proceding, the court should not speculate on the possible effectiveness of that fraud. See *Hazel-Atlas Glass Co.* v. *Hartford-Empire Co.*, 322 U. S. 238, 247 (1944); where there had been a successful fraudulent plan to secure a favorable judgment. In holding the judgment invalid, this Court did not think it necessary to "accurately . . . appraise the influence . . ." of the prior fraud, and held the defrauding parties were "in no position" to raise that issue. See, *Alston* v. *Shriver,* 105 So.2d 785 (Fla. 1958); *Rasquin* v. *Cohen,* 92 N.H. 440, 33 A.2d 404 (1943).

But it is not necessary to find that defendants are estopped from raising an issue as to the sufficiency of the concealments. Judged by the proper legal standard, those concealments clearly are sufficient to set the settlement aside.

The standard applicable here is the one employed where a duty to disclose exists or where there has been a fraud on the courts, namely: Is the non-disclosed evidence such that it *might* have changed the result.[36]

Thus, in cases involving trustees who are under a duty to make full disclosure of all relevant facts after, as well as before, litigation begins, the courts require only that the non-disclosed evidence be such that it "might have changed the attitude of the consenting parties."[37] Even if it is "problematical" that the withheld documents will affect the eventual result, courts have set aside an earlier judgment.[38] This rule has been applied in both the federal, *Hewitt* v. *Hewitt,* 17 F.2d 716 (9th Cir. 1927); and state courts, *Boston & Maine R. R.* v. *Delaware & Hudson Co.,* 238 App. Div. 191, 264 N.Y. Supp. 470 (3d Dep't 1933); *Matter of Lautz's Estate,* 128 Misc. 710, 220 N. Y. Supp. 782 (Surr. Ct. Erie Co. 1927); *Matter of Dittmar's Estate,* 154 Misc. 28, 276 N.Y. Supp. 579 (Surr. Ct. N.Y. Co. 1934); *Matter of Teller's Estate,* 277 App. Div. 937, 98 N.Y.S.2d 875 (4th Dep't 1950).[39]

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[36]There is, of course, no absolute standard by which non-disclosures are tested. The courts have developed and applied tests consistent with the policy consideration relevant to the class of case being decided. The strong policy in favor of a duty to disclose under the Securities Acts and the strong policy against fraud upon a court combine here to make necessary a broad standard as to what is sufficient to constitute an actionable fraud. Another reason for a broad standard is found in Judge Friendly's dissent (R. 2368):

> "This very fact, that directors accused of malfeasance have so much control over the evidence, both documentary and non-documentary, relating to their misdeed, makes it vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that a breach was not consequential to a most icy scrutiny."

[37]Matter of Lautz's Estate, 128 Misc. 710, 220 N.Y. Supp. 782 (Surr. Ct. Erie Co. 1927).

[38]Ibid.

[39]In like manner, § 14(a) requires disclosure of all information that "might" affect the shareholder's vote; in such cases, the court will not "speculate" on the effect of non-disclosed information. S. E. C. v. May, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd* 229 F.2d 123 (2d Cir. 1956); Central Foundry Co. v. Gondelman, 166 F. Supp. 429 (S.D.N.Y. 1958).

Similarly, in *United States* v. *Consolidated Laundries Corp.*, 291 F.2d 563, 570 (2d Cir. 1961), where the government attorney was under a duty to make certain that all evidence was available for use by his opposing counsel, undisclosed documents were deemed sufficient to require a new trial because they were "highly relevant", even though it was "impossible to know whether the result of the trial would have been different".

Here we are faced with a duty to disclose based upon policy considerations at least as compelling as those in the trustee cases, and analogous to those in *Consolidated Laundries, supra.* [40] If the concealments here are to be tested at all, the test should be the one applied in those cases, *i.e.*, the one propounded by Judge Friendly: "The test should be . . . whether there is any fair basis for thinking the undisclosed evidence might have changed the result".

The split between Judge Friendly and Judge Moore on the proper legal standard was a result of their difference as to the existence of a duty to disclose. Judge Moore, believing that the directors ceased being fiduciaries at the start of

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[40] Judge Friendly has stated the relevance of *Consolidated Laundries:*

> "Although the decision in *Consolidated Laundries* was based upon our duty to insure a fair administration of criminal justice in the federal courts, there are enough similarities between a prosecution and a derivative suit against self-dealing fiduciaries to make the test of materiality in that decision highly pertinent. Both the prosecutor and the director-defendant are charged with the duty of assuring that their adversaries are honestly and fairly treated. Just as a criminal court is entrusted with the protection of defendants from overzealous prosecution, a court passing on the settlement of a derivative action is charged with the protection of the absent shareholders, whose interest may be represented inadequately or not at all by the time a settlement has been negotiated. Where deliberate dereliction on a director's part has prevented the court from safeguarding the interests entrusted to it, a reasonable possibility that the undisclosed evidence might have led to disapproval or to a substantial increase in a settlement should suffice for reopening."

the litigation and seeing no duty to disclose, saw no policy considerations beyond finality-of-litigation and adopted the standard applied to newly-discovered evidence in cases where the parties have been involved in arm's-length transactions.

The settlement we seek to set aside did not dispose of an ordinary claim for money damages between two arm's-length adversaries, nor is it an action to set aside a settlement for fraud committed by a party who was under no obligation to disclose either to his adversaries or to the court. On the contrary, this is a suit seeking relief from a settlement fraudulently procured by a fiduciary whose duties to the shareholders and the court arise out of the policy underlying the statute as well as common law concepts.[41] Failing to recognize these considerations, Judges Moore and Kaufman erroneously demanded a showing that the excluded evidence would probably, rather than might, have changed the result.[42]

D. *The Concealments From the Federal and State Courts When Approval of the Settlement Was Obtained Aggravated the Fraud.* The question of whether there were sufficient concealments to set aside the settlement is not limited to the fraud before the Referee. When approval of the settlement Ireland had negotiated for Kirby was sought in the

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[41]Indeed, even if there were no common law basis for the standard of disclosure urged here, this Court would be free to fashion new federal standards consistent with the overriding public policy. See: SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).

[42]This is the test applied to motions for a new trial. Judge Friendly's dissent provides the most cogent response to the majority's view:

> "I cannot agree that when judicial approval of a settlement by a fiduciary has been procured by culpable non-disclosure of evidence by his confederate fiduciaries, the test of materiality applicable on motions for a new trial on the ground of newly-discovered evidence has any relevance; indeed, in the very decision cited by the majority, Judge Kaufman carefully distinguished between newly-discovered evidence *simpliciter* and the recantation of a witness, 131 F. Supp. at 120."

federal and state courts, the fraud before the Referee was repeated; the information concealed during the hearings was not revealed to either the federal or state courts.

Moreover, the earlier fraud was aggravated by two further concealments: Neither Kirby nor Ireland disclosed that Ireland now knew, and had informed Kirby, that Young had given perjured testimony during the earlier hearings (R. 417). Also, neither Kirby nor Ireland revealed that Ireland, who purportedly was representing Alleghany in the settlement hearings before both courts, had, in fact, been Kirby's personal representative in the negotiations which achieved the settlement (R. 427-428, 481-482, 349, 370-371). As Kirby's representative, it was Ireland's job to secure settlement as profitable for Kirby and as unprofitable for Alleghany as was possible. As Alleghany's counsel, it was his job to examine the settlement and tell the court if he believed that it was as good a settlement as his client, Alleghany, could receive. The record shows he took his former job more seriously. In pursuit of Kirby's interest, he had offered a bribe to the plaintiffs' representative (R. 2286, 486-487). In representing Alleghany, Ireland concealed from the courts his role as Kirby's negotiator and allowed those courts to approve a settlement which he knew, or should have known, to be grossly inadequate.

The law requires that in actions of this sort, the corporation be represented by independent counsel whose relationship to the defendant-directors will create no conflict of interest. Even the possibility of conflict is enough to require that new counsel be retained. *Lewis v. Shaeffer Stores Co.*, 218 F. Supp. 238, 240 (S.D.N.Y. 1963), *Garlen* v. *Green Mansions, Inc.*, 9 A.D.2d 760, 193 N. Y. S. 2d 116, 117 (1st Dep't 1959); see Note, *Independent Representation for Corporate Defendants in Derivative Suits*, 74 Yale L.J. 524. It is hard to conceive of counsel for Alleghany who would fall shorter of that standard than

Charles T. Ireland, Jr., who had represented and was beholden to Kirby.[43]

Kirby and Ireland were under a duty to bring all facts of which they had knowledge and which bore on the fairness of the settlement to the attention of the court when approval was sought.[44] They were under a like obligation as to the members of the Alleghany Board at the time that Board voted to accept the settlement and release Alleghany's claim against Kirby. Failure to do so voids the settlement and the release. *Irving Trust Co.* v. *Deutsch,* 73 F.2d 121 (2d Cir. 1934), cert. denied, 294 U.S. 708 (1935); *Maas* v. *Lonstorf,* 194 Fed. 577 (6th Cir. 1912).

The trial judge, and the Circuit Judges who affirmed, ignored these failures to disclose to the federal and state courts and to the Alleghany Board when they held that the fraud was insufficient to require that the settlement be set aside.

Judge Friendly, however, recognized the significance of the concealments from the federal court, as well as the state court (R. 2360). He also supplied the answer to the contention that there was no duty to disclose at this stage because the shareholders were the true representatives of the corporation (R. 2367-2368):

> "I cannot at all agree with the implication in my brother Moore's opinion that standard procedures for the approval of settlements afford sufficient safeguards in the 'big' case, or that they did in this one. The plaintiff stockholders or, more realistically, their attorneys have every incentive to accept a settlement

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[43]At the time of the settlement Ireland was employed by Alleghany which Kirby controlled. Upon reacquiring control of Alleghany at a later date, Kirby made Ireland President of Alleghany at a salary of $100,000 a year (R. 49).

[44]It is not contended that Ireland knew of the information concealed in the hearings before the Referee. He did know of Young's perjury (R. 417) and, of course, he was aware of his own dual role.

> that runs into high six figures or more regardless of how strong the claims for much larger amounts may be. The percentage allowance in stockholders' action is 'reduced as the amount of recovery passes the million dollar mark' . . . and a juicy bird in the hand is worth more than the vision of a much larger one in the bush, attainable only after years of effort not currently compensated and possibly a mirage."

He observed:

> "Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork . . . I cannot see how the attorneys proposing the settlement were any more 'representative' than the attorney opposing it; the stockholders' true representative was the court, which was allowed to proceed in ignorance of vital information."

E. *Kirby Cannot Benefit by the Fraud of Young and Purcell.* The focus, in the dissent, on the concealments of Young and Purcell required a finding that Kirby could not benefit by a settlement fraudulently procured by his co-fiduciaries. The trial court rejected this theory and refused to admit evidence of concealments by Young and Purcell (e.g., the Waag-Purcell-Young correspondence described *supra*, pp. 9-11).[45] The majority opinion did not treat this question. The concurring opinion, however, agreed in principle with the dissent on this aspect of the case. It stated: "In terms of its reliability as a fair and genuine adjudication of the adequacy of the settlement, the Referee's approval would seem to stand on no firmer grounds merely because the fraud which kept material documents from the attention of the

[45] It was to give defendants an opportunity to defend against such erroneously excluded evidence that Judge Friendly would have remanded for further hearing (R. 2369).

Zenn plaintiffs may not be directly imputed to Kirby." (R. 2348).[46] That finding is sound. It is amply supported by the cases whether Kirby, Young and Purcell are looked on simply as co-fiduciaries or treated as co-conspirators.

In *Jackson* v. *Smith*, 254 U.S. 586 (1921), Justice Brandeis, writing for this Court, held that one who knowingly joins a fiduciary in a breach of trust becomes jointly and severally liable with that fiduciary. *Lawrence Warehouse Co.* v. *Twohig*, 224 F.2d 493 (8th Cir. 1955); *Sexton* v. *Sword S. S. Line*, 118 F.2d 708 (2d Cir. 1941); *Irving Trust Co.* v. *Deutsch*, 73 F.2d 121, 125 (2d Cir. 1934), cert. denied 294 U.S. 708 (1935); *Wechsler* v. *Bowman*, 285 N.Y. 284, 34 N.E.2d 322 (1941). There can be no doubt that Kirby knowingly joined with his co-fiduciaries in their fraud. He was a knowing party to the original illegal stock transaction, and the violation of § 14(a), of which the subsequent concealments of Young and Purcell were a continuing aspect. Moreover, he had been advised by Ireland of Young's perjury during the course of the settlement hearings, and he had joined with Young and Purcell in briefs to the Referee and the court asserting that no inside information existed (R. 1637-1638).[47]

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[46]A recent edition of the Yale Law Journal, which discusses the *en banc* decision in this case, contains a persuasive formulation of this argument: "Kirby sought to invoke the *Zenn* settlement as res judicata in the present litigation, and accordingly, he had no justification for claiming that the non-disclosures of his cohorts in *Zenn* should not be used to defeat his defense of res judicata. Judge Moore seems to suggest at several places that Kirby should not be blamed for the conduct of his accomplices, apparently forgetting that it is Kirby who seeks to protect himself from liability by introducing the *Zenn* settlement". Note, *Collateral Attack of Judicially-Approved Settlements of Shareholders's Derivative Suits*, 74 Yale L.J. 1140, n. 6 (1965).

[47]Under the theory that Kirby is liable for the acts of Young and Purcell because they were co-conspirators, as well as co-fiduciaries, knowledge of the fraud in the settlement proceedings need not be proven (*infra*, p. 43).

Application of the co-fiduciary liability rule does not require a finding of conspiracy.[48] Here, however, the insiders were not only co-fiduciaries but were co-conspirators in a plot to defraud the shareholders. The existence of that conspiracy provides independent legal support for the conclusion that Kirby cannot claim the benefit of the fraudulently obtained settlement.

The acts in concert by Kirby, Young and Purcell to obtain corporate property for themselves constituted a conspiracy, and their receipt of such property was an overt act in execution of the conspiracy. *Bosworth* v. *Allen,* 168 N.Y. 157, 167, 61 N.E. 163, 165 (1901); *Penn-Texas Corp.* v. *Sarlie,* 15 Misc. 2d 626, 628, 181 N.Y.S. 2d 750, 752 (Sup. Ct., N. Y. Co. 1958).[49] See *Maggiore* v. *Bradford,* 310 F.2d 519, 521 (6th Cir. 1962), cert. denied 372 U. S. 934 (1963). The concealments by Young and Purcell during the settlement hearings were in furtherance of the common objective of the conspiracy. Had the critical IDS forecasts and projections been disclosed to the Referee, the objective of the conspiracy would have been lost; none of the conspirators could have kept their illegally-taken shares. Under the law of conspiracy, the extent of Kirby's role in the fraud on the Referee is of no moment. Having joined it does not matter whether Kirby did or did not participate in, or know of, Young's and Purcell's concealments. As Judge Friendly said: "If, as the evidence shows, Young, Kirby and Purcell, conspired to make an unlawful appropriation . . . of IDS Class A stock . . . , they remained bound to the end" (R. 2351-2352). *Lile* v. *United States,* 264 F.2d 278, 281 (9th Cir. 1958); *Leyvas* v. *United States,*

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[48]See: Asphalt Construction Co. v. Bouker, 150 App. Div. 691, 692, 135 N.Y. Supp. 714 (1st Dep't), aff'd, 210 N.Y. 643, 105 N.E. 1080 (1912); Lonsdale v. Speyer, 249 App. Div. 133, 141, 291 N.Y Supp. 495, 505 (1st Dep't 1936); Gerdes v. Reynolds, 30 N.Y.S.2d 755, 773 (Sup. Ct. N.Y. Co. 1941).

[49]*Penn-Texas* held (p. 628): "Concerted activity to produce the breach of trust is sufficient support for the allegation of conspiracy."

264 F.2d 272, 274 (9th Cir. 1958) cert. denied 359 U.S. 936 (1959); *Winkler-Koch Engineering Co.* v. *Universal Oil Products Co.*, 79 F. Supp. 1013, 1018 (S.D.N.Y. 1947). See *Pinkerton* v. *United States*, 328 U.S. 640, 646-7 (1946).

> "A partner for whose benefit the facts were concealed can no more preserve a settlement thus obtained than one who was on the front line." (Friendly, J., R. 2351).[50]

II. SETTLEMENT OF FEDERAL CLAIMS REQUIRES APPLICATION OF FEDERAL STANDARDS. HENCE, FEDERAL POLICY WAS ERRONEOUSLY FRUSTRATED BY CONSIDERATIONS OF *ERIE*, COMITY AND RES JUDICATA IN THE COURTS BELOW.

Where, as here, a judicially approved settlement of a claim arising under the Federal Securities Acts is attacked as having been fraudulently obtained, the criteria for measuring that fraud and determining whether it should be rectified must be found in federal law. It is immaterial whether the court giving its approval was a federal or state court. The critical question is whether standards of investor protection consistent with the policy of the Securities Acts have been met. If they haven't, the settlement should be set aside no matter what court approved it.

Here, the settlement under attack disposed of a state court complaint explicitly alleging violations of the Securities Exchange Act of 1934 (R. 705). That complaint was

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[50] That the trial judge missed this point is illustrated by his remark (A. 318):

> "Maybe Mr. Young was not telling the truth, that wouldn't be unusual. I don't see that this is an issue that I have to decide in this case."

cast in the federal mold and thereby called for the application of federal law.[51] Moreover, the stipulation of settlement under consideration by the state court Referee expressly provided for dismissal of the identical claims then pending in the parallel action in federal court (R. 757).

Nonetheless, in determining whether the insiders' conduct in the prior actions was fraudulent, the trial court ignored federal policy and standards, declaring that *Erie R.R.* v. *Tompkins,* 304 U.S. 64 (1938), and the existence of a state court judgment required it to analyze the duty of disclosure and the existence of fraud in terms of New York law (218 F. Supp. at 183-84). It thereupon held that the insiders' fraud upon the Referee was, if anything, "intrinsic fraud", a variety of fraud which would not cause a New York court to set aside a previous judgment (218 F. Supp. at 184-85).

No member of the Circuit Court expressed the belief that *Erie* required the application of state law.[52] Judge Kaufman's concurring opinion, however, contained a related misconception. He thought that because this was an attack upon a settlement approved by a state court, "considerations of *res judicata* and comity must be taken into account; institutional imperatives and the necessity of finality in litigation are of far greater significance" (R. 2350). Judge Moore, finding no duty of disclosure, apparently saw no basis for a plenary action in the federal court. He viewed this suit as an attempt to "have a federal district

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[51]Cf., J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Davis v. Wechsler, 263 U.S. 22 (1923); Pan American Petroleum Corp. v. Superior Court, 366 U.S. 656, 662 (1961); Levine v. Silverman, 43 Misc.2d 415, 417, 251 N.Y.S.2d 68 (Sup. Ct. Monroe Co. 1964); Malkan v. General Transistor Corp., 27 Misc.2d 677, 207 N.Y.S.2d 345, 347-8 (Sup. Ct., Queens Co. 1960).

[52]Nonetheless, the 4-4 *en banc* opinion expressly affirms the District Court judgment. At best, therefore, the law as to whether *Erie* applies is left ambiguous.

court act, in effect, in an appellate capacity to review decisions of the Referee and the New York Supreme Court" (R. 2341). Judge Friendly implicitly rejected that position as well as Judge Kaufman's view that considerations of finality, comity and "institutional imperatives" rather than investor protection were the focal points of this case (R. 2350-2351).

These divergent views in the lower courts should be resolved by reference to the interest intended to be protected by Congress and to the choice of law rule applied by the courts where claims under federal laws have been allegedly fraudulently settled.

Unquestionably, in these circumstances, the criteria for measuring the fraud of Kirby, Young and Purcell during the settlement proceedings must be the federal law and standards. *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964). Where Congress has acted to create federal rights, neither state procedural nor state substantive law can be applied so as to narrow the protection accorded by the federal statute, *American Railway Express Co.* v. *Levee,* 263 U.S. 19 (1923), and see *Davis* v. *Wechsler,* 263 U.S. 22, 24 (1923):

> "Whatever springes the state may set for those who are endeavoring to assert rights that the state confers, the assertion of Federal rights, when plainly and reasonably made, is not to be defeated under the name of local practice."

This rule extends to all the incidents of the federally created right, *Garrett* v. *Moore-McCormack Co.,* 317 U.S. 239 (1942); *Levitt* v. *Johnson,* 334 F.2d 815 (1st Cir. 1964), cert. denied 379 U.S. 1961 (1965). In particular, it requires both state and federal courts to look to federal law

in determining whether a settlement and release of a claim under a federally-created right has been fraudulently obtained, *Dice* v. *Akron C. & Y. R. R.*, 342, U.S. 359 (1952); *Garrett* v. *Moore-McCormack Co., supra.*

Garrett was a Jones Act case, and Dice an F.E.L.A. case. Both involved attacks upon settlements and releases of claims arising under a federal statute designed for the protection of a particular class. In each instance, those releases had been sustained under state law, and in each instance, this Court reversed, holding that neither state concepts of fraud and release nor state court rules as to burden of proof could be allowed to frustrate the protection intended by Congress.

The rule that federal law must govern the validity of settlements of claims arising out of federally created rights is not confined to Jones Act or F.E.L.A. cases. See, e.g., *Stella* v. *Kaiser*, 221 F.2d 115 (2d Cir.), cert. denied 350 U. S. 835 (1955) (settlement of Securities Exchange Act claim); *Winchester Drive-In Theatre, Inc.* v. *Twentieth Century Fox Film Co.*, 351 F.2d 925 (9th Cir. 1965) (settlement of Sherman Act claims); *Dale Hilton, Inc.* v. *Triangle Publications, Inc.*, 198 F. Supp. 638, 639 (S.D.N.Y. 1961) (settlement of Sherman Act claims).

The policy reasons which motivated this Court to declare the necessity of developing and applying federal criteria to all the incidents of federally-created statutory rights are present here:

> (a) As in *Levee*, *Dice* and *Garrett*, a federal statute gave rise to the claim allegedly settled. Therefore, federal common law attuned to the Congressional purpose must be fashioned to implement the policy of the statute and protect the federal right. *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964); *Textile Workers* v. *Lincoln Mills*,

353 U. S. 448 (1957); *Capital Service Inc.* v. *NLRB*, 347 U.S. 501 (1954).[53]

(b) As in *Levee, Dice* and *Garrett,* there is a need here for uniform enforcement to effectuate the policy of the federal statute: Investors in publicly-held companies are spread throughout the United States and should not have their federal rights foreclosed in diverse litigation in state courts which may not insist upon standards of disclosure comparable to those demanded by the federal statute.

(c) As in *Levee, Dice* and *Garrett,* the Court here is faced with the possibility that the federal right would not only lack uniform enforcement, but that it could actually be defeated by existing state law.

Since the settlement here under attack disposed of federal claims pleaded in parallel federal and state court actions, disposition of the issue as to federal-state relations is made easier. By approving the settlement according to its own standards, the state court not only disposed of the federal claim but directly precluded further prosecution of the federal action asserting that claim.[54]

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[53]It was, after all, the inadequacy of existing investor protection under state laws and common law that prompted Congress to enact the Securities Act. See SEC v. Capital Gains Research Bureau Inc., 375 U. S. 180, (1963). The Courts should not now limit the scope of that remedial legislation by ignoring it and looking to the inadequate provisions of state law in cases where the rights created by the federal act are drawn in question.

[54]Significantly, Kirby was served only extraterritorially in the District Court action under the Securities Acts provisions, and he answered a complaint only in that court. Moreover, all pre-settlement discovery was had in the federal action. Thereafter, Kirby and Purcell only appeared "specially" in the state court for purposes of the settlement. In sum, Kirby elected to use the state court to settle a federal action which was the only action pending against him. Consequently, it makes no difference here that common law claims under state law also were settled. See Lyon v. Quality Courts United, Inc., 249 F.2d 790, 794 (6th Cir. 1957).

The District Court, therefore, erred in believing that *Erie* required it to look to state rather than federal criteria in determining whether the settlement of the prior state and federal actions was procured by fraud. Judge Kaufman likewise erred in believing that comity similarly required undercutting the federal right. As the foregoing discussion shows, there can be no concept of federal-state law relationships or comity superior to the necessity of assuring that investors in publicly-held companies are given the protections Congress intended for them in enacting the Securities Acts. If those protections have been evaded by non-disclosure and concealment in prior litigation, then federal law requires that the fraud be rectified (Point I, *supra*).

Nor is there any concept of res judicata or institutional imperative of finality that can or should interfere with rectifying the fraud shown on this record.

Res judicata has no application because the claim here asserted was neither asserted nor adjudicated in the prior actions. It could not have been. The fraud now sued upon was perpetrated to accomplish the inadequate settlement of the prior litigation. The question as to whether there was fraudulent non-disclosure or concealment during the settlement proceedings was not at issue in those proceedings. Consequently, it is a new and distinct claim for relief unaffected by the rules of res judicata.[55]

Moreover, we believe that there are no imperatives as compelling as those which argue for the application of the correct federal standard. Putting aside the necessity for a just result (a not insignificant imperative in itself), the necessity of affording investors in publicly-held companies

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[55]Even if the principles of res judicata were applicable here, public policy considerations explicit in the Federal Securities Acts would require that the settlement be opened up so that the federal standards could be met. See Mercoid Corp. v. Mid-Continent Investment Co., 320 U.S. 661, 670 (1944).

the full measure of protection Congress intended for them is plainly the controlling imperative here. Finality is less important than fair dealing by corporate managers. To rule that the state settlement, fraudulent by federal standards, should stand unassailable because of some institutional imperative would mock the Congressional purpose in enacting the Securities Acts, and would make settlement proceedings a more defective device than they already are (see Judge Friendly's dissent, R. 2367-2368). It would encourage rather than deter concealment by corporate insiders. The balance of interest in today's society must favor disclosure and the federal standard.

CONCLUSION

The rule of this case will set a standard for corporate behavior throughout the country. It will either provide public investors with the assurance that they can safely entrust their funds to corporate directors; or it will encourage those directors so inclined to abuse their trust, to mislead when challenged and to conceal when sued.

In sum, we ask for a rule necessary to effect the policy of the federal Securities Acts, and well grounded in common law; a rule so right it is virtually compelled by conscience alone. The time has come for the federal courts to adopt, toward those fiduciaries who control our corporations, an attitude of "uncompromising rigidity." *Meinhard* v. *Salmon,* 249 N.Y. 458, 164 N.E. 545 (Cardozo, J.) (1928).

Accordingly, we respectfully request that the judgment be reversed and an order made declaring that the settlement and consequent releases and judgment are no bar to the prosecution of this action and directing the district court to rescind the illegal IDS stock transaction and to assess the damages caused to Alleghany by the fraudulent settle-

ment, or in the alternative, to hold a prompt trial of the claim based on the illegal IDS stock transaction and the false and misleading proxy statements, or in the further alternative, to remand to the district court for further hearing in order to give defendants an opportunity to meet the evidence erroneously excluded.

Respectfully submitted,

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January 21, 1966

APPENDIX

Securities Exchange Act of 1934

§ 2 (15 U. S. C. § 78b). *Necessity for regulation*

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis

for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit. June 6, 1934, c. 404, § 2, 48 Stat. 881.

Appendix

Securities Exchange Act of 1934

§ 14 (15 U. S. C. § 78n). *Proxies*

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. June 6, 1934, c. 404, § 14, 48 Stat. 895.

§ 27 (15 U. S. C. § 78aa). *Jurisdiction of offenses and suits*

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by

this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts. June 6, 1934, c. 404, § 27, 48 Stat. 902; June 25, 1936, c. 804, 49 Stat. 1921, June 25, 1948, c. 646, § 32(b) 62 Stat. 991; May 24, 1949, c. 139, § 127, 63 Stat. 107.

Rule X-14A-9. *False or Misleading Statements*

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication written or oral containing any statement which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the

solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this rule:

(a) Predictions as to specific future market values, earnings, or dividends.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.